The World Bank and the IMF are not in good health. Kenneth Rogoff, a former chief economist of the Fund, suggests a course of treatment

AS THE two Bretton Woods sisters turn 60, the tough love of the International Monetary Fund and even the free love of the World Bank go largely unrequited. Nowadays the twins, never universally admired, are constantly attacked from the left, from the right, from the centre and, sometimes, by each other. For the Fund and the Bank, another birthday all too often means being the piñatas at their own party. Some of the criticism is justified, some bogus. Both institutions still have a useful role to play and they remain a clear overall plus for the world—but they can and should be improved.

Start with the Bank, which is actually a complex hybrid of aid agency, long-term development lending bank and technical-assistance outsourcing centre. Famously, the Bank was conceived mainly to help Europe rebuild after the second world war: hence the name of its main lending “window”, the International Bank for Reconstruction and Development, or IBRD.

Without doubt, the most powerful leader the Bank ever had, at least until its current president, was Robert McNamara, a former secretary of defence of the United States. (By convention the Bank’s president has always been an American.) During his time in charge, between 1968 and 1981, the Bank littered the developing world with pharaonic infrastructure projects that made it few friends among greens or budding anti-globalisation activists. Worse still, many developing countries began accumulating debts to the Bank which, whether originally granted on concessional terms or not, still grew a lot faster than their economies, some of which were actually shrinking. Small wonder, then, that the Bank also became unpopular in many developing countries. (Mr McNamara is the star of a recent documentary “The Fog of War”, in which he reminisces about his time as secretary of defence during the early years of the Vietnam war. The sequel, “The Fog of Development”, is keenly awaited.)

Today, things are very much better on the public-relations front, albeit partly thanks to the Bank's
gargantuan external-relations department (of more than 300 people). The Bank rightly gets a lot of credit for its growing recognition that “soft” issues such as governance and institutions are fundamental to economic growth and the reduction of poverty. The Bank's current president, James Wolfensohn, has spoken out early, often and boldly about the corrosive effects of corruption. Meanwhile, the Bank's lending priorities have changed over the past 20 years, with more support for health, governance, women and education, in addition to lending for traditional infrastructure projects. So far as technical assistance is concerned, country clients can tap the Bank's world-class experts in diverse areas such as education, nutrition, financial-sector regulation and the prevention of AIDS. Finally, under the rubric of “country ownership”, the Bank has tried to tailor its lending policies so that clients have more say in their design.

All of which is good. The bad news, though, is that the Bank still suffers from a couple of fundamental structural flaws. At the very least, these prevent it from realising its full potential. The first, and far more serious, of the flaws has to do with the Bank's ill-conceived financial structure.

In essence, the Bank is a “hedge fund with a heart”. The Bank's main branch for middle-income countries, the IBRD, has only a small amount of paid-in capital. It finances most of its lending activities, which amount to more than $100 billion, through borrowing. That is, the IBRD taps international capital markets using its triple-A rating, and then lends to developing countries and emerging markets at a mark-up of between ½% and ¾%, generally (but not always) far below the rate at which they could borrow on their own. The Bank uses the difference to help defray the Bank's $1.5 billion in operating expenses, including the cost of its 10,000-plus employees. If borrowers and lenders (holders of the Bank's bonds) are satisfied with these terms, the deal seems mutually beneficial: who could possibly object? Look a little more closely.

To begin with, the Bank's developing-country junk-bond portfolio is patently risky. The fact that the Bank has not yet seen mass defaults is partly just a matter of luck (the boom of the 1990s kept many junk-bond portfolios afloat). In addition, a complex maze of bilateral debt and aid deals has periodically helped extricate the World Bank from some tight spots, concealing what might otherwise have been default. Today, the Bank is heavily invested in Argentina, a country that has defaulted on private creditors and is openly voicing thoughts of defaulting on official ones. Of course, everyone believes that the G7 group of rich countries and their friends would bail the Bank out in an emergency. Hence it retains its triple-A rating for now. But this means that there are hidden actuarial costs to taxpayers, as the Meltzer Commission reported to Congress in 2000, and as I had found in my own research published some ten years earlier.

A bank must lend

There is a potentially more serious problem, though. The Bank needs to push out loans continuously. This sometimes leads it to seduce countries that are already borrowing too much into borrowing more. Remember the 1990s? The Bank was piling all sorts of loans on to Latin American governments, whose failure to strengthen their budget positions adequately was a major cause of debt crises in Argentina, Brazil and elsewhere. Today, the Bank is apparently preparing to ramp up IBRD loans to India, a country whose debt-to-GDP ratio already exceeds 80% and which is running general government deficits of over 10% a year.

This is not to argue against giving aid to middle-income countries. The problem arises when the aid takes the form of loans. Really, what possible rationale can there be for the World Bank to make loans to investment-grade borrowers such as China, with $470 billion in foreign-exchange reserves? What of its activities in Russia, a country with gobs of oil, more than $80 billion in reserves, and a debt ratio that stands at less than 12% of income? Some argue that there is an efficiency gain from Bank involvement; that is why it can charge such low rates. More likely, the senior status accorded to the Bank's loans just means that the country will have to pay higher rates on all its other borrowing.

When Englishman John Maynard Keynes and American Harry Dexter White first designed the Bank, one might have forgiven them for thinking that an official loan window would deal with what economists call a missing market. But if they were still alive, and could see today's highly liquid private markets, I suspect that they, too, would agree that the IBRD's lending window should be closed. So too should the Bank's much smaller International Finance Corporation (IFC) window, which is also market-based. The Bank should be reduced to its defensible aid core: that is, to its International Development Assistance (IDA)
window. And IDA funds should become 100% outright grants, rather than 70% as they are now. This again is a conclusion reached by the Meltzer Commission and by myself ten years before. The idea is not new—but it is still right, and has yet to be acted upon.

If the case for shifting from loans to grants is so compelling, why haven't politicians accepted it? One reason is tremendous resistance from continental Europe, where many leaders are legitimately concerned that an excessive reliance on aid will make the World Bank hostage to a fickle and inward-looking United States Congress. But the problem of financing steady flows of aid is surmountable. Britain's chancellor of the exchequer, Gordon Brown, has made an excellent suggestion. Adopting the essentials of his approach, countries would issue bonds whose proceeds would be dedicated by treaty to the World Bank. Legislatures will still have to adopt the initial treaty, but once locked in at an opportune moment, future Congresses would find it harder to back out.

The second problem with the Bank today is accountability. It is good that countries can call on Bank experts to help them with a wide range of problems, but how can one really tell what kind of assistance the Bank should prioritise if there is no market feedback? My own experience is that countries will always tell you they loved your technical-assistance team. Ask them to defray the slightest costs, however, and they may change their tune. The Bank needs to come up with new ways to assess the performance of its diverse empire, and to price its products appropriately. Still, my sense from the inside is that the Bank is doing a pretty good job in many areas. At the very least its technical assistance conforms to the good physicians' principle, "First, do no harm."

Can one say the same of the International Monetary Fund? Is its policy advice as horrible as some critics seem to think? And what missing market does it fill? Should its lending window, like that of the IBRD, be scrapped?

In my view, the Fund's policy advice has usually been much better than it is given credit for. A book would be required to answer properly even some of the many charges that have been made against the Fund. Briefly, though, the most persistent and at the same time most confused accusation is that the IMF insists on austerity during country-debt crises. This simply confuses correlation and causality. A country calls on the Fund precisely when all its other lenders have turned their backs, when even its own citizens have lost confidence. In such a situation, the country would have to close its deficit—that is, raise taxes or lower government spending—with or without the Fund. Thanks to emergency Fund bridge loans, such measures are less harsh than they would otherwise have to be. Just because one sees doctors around plagues doesn't mean they cause them. Of course, the Fund has made mistakes, notably at the outset of the Asian crisis. There, although there was a run on countries' international debts, many still had the capacity to lessen austerity by tapping domestic markets, a reality the Fund was slow to acknowledge.

What about capital controls? Many leading scholars, including Dani Rodrik, Joseph Stiglitz and Jagdish
Bhagwati, portray the Fund as relentlessly pushing countries to open their capital markets prematurely, making it the prime culprit in every financial crisis. Speaking with old hands at the Fund, my sense is that in the mid-1990s, there was some measure of truth in this charge. However, for some time now, the Fund's advice has become almost too eclectic, given the growing body of research on the long-term pernicious effects of capital controls.

Besides, what, really, are the main lessons of the past 40 years of international financial crises? Surely they are: (a) there are limits to how much you can plug up capital markets as economies become more financially sophisticated, and (b) overly rigid exchange-rate regimes are a recipe for disaster, setting up one-way bets for speculators. I venture that if Asia had had somewhat more flexible exchange rates in the 1990s, it would have suffered a mini-crisis and not a maxi-crisis. Anyway, which middle-income country is nowadays the exemplar for advocates of capital controls—Hugo Chávez's Venezuela?

Finally, many argue that the mere existence of the Fund has led to an increase in international debt crises. Perhaps, but debt crises have been going on for a long time. Turkey, Brazil, Mexico, Argentina and Venezuela all defaulted numerous times before the advent of the Fund, and the results were pretty ugly then as well.

The Fund should continue to develop and improve its advice. For example, in today's world of very low inflation, the Fund probably remains a bit too concerned about whether central banks are ambitious enough in their inflation targets. Many countries rightly complain that no matter how low they get their inflation, the Fund always wants them to lower it more. The Fund's bias probably made sense in 1992, when 44 countries had inflation rates over 40%, but it makes far less sense today when only a couple of countries still have very high inflation. Perhaps also there is more scope for giving borrowing countries greater control ("ownership") of their stabilisation policies. But beware: my sense is that whenever a country's stabilisation programme fails, the Fund will be deemed the owner, no matter how complete the country's control.

The worst call of all?

Making the right decisions in developing-country debt crises will always be difficult. Famously, in the middle of the Asian crisis of the 1990s, the World Bank sent its chief economist to China: he urged them to move off their currency peg, evidently believing that a depreciation of the renmimbi would stimulate demand in the region. The Fund was concerned that a Chinese devaluation would have dealt a crushing blow to the other Asian countries, which were just beginning to feel the benefits of their currency depreciation through their exports to the West. In the event, the Chinese held their peg, and the other Asian countries emerged from their recessions faster than most predicted. With hindsight, the Bank's push to have China devalue looks like the great wrong call of the Asian crisis. But who can be sure? Making such calls in the confusion of the moment is hard, and always will be.

Today, the situation is perhaps reversed. The Fund needs to press Asian countries, especially China, to introduce more flexibility into their exchange-rate systems, not least to help curb America's growing current-account deficit. True, the weakness of the dollar has relieved the pressure on some of the Fund's major problem debtors, including Brazil and Turkey, and that is good. But the fear remains that the international financial system is simply replacing a number of conventional emerging-market debt bombs with an advanced-country nuke. With the United States facing open-ended security costs and risks to its energy supplies, the "Bretton Woods II" system of fixed exchange rates in Asia may be doomed to break up, perhaps with the same unfortunate consequences, as the original European version did in the 1970s. Many legal experts say that the Fund's charter forbids it to challenge a country's exchange-rate regime. If so, the charter had better be changed.

Finally, a word on the financial structure of the Fund, which is admittedly a tricky issue. Again, my long-held view is that the Fund would serve better if it made no loans. In a nutshell, the Fund's current resources of $150 billion seem like enough to cause moral-hazard problems (that is, to induce excessive borrowing) without being enough to deal with a really deep global financial crisis. The Fund is just too politised to be a consistently effective lender of last resort, and if its financial structure is not changed, there are always going to be Argentinas. (If nothing else, there will always be Argentina.)

I am unimpressed by the superficial patches introduced during the era of the Clinton Treasury, and also
by the latest push to introduce “access limits” to prevent the Fund from handing out over-sized bail-out packages. If Brazil had been given only an additional $15 billion in August 2002 instead of $30 billion, I believe its programme would have collapsed. What good is it to throw a man ten feet of rope if he is drowning in 20 feet of water?

In Robert Rubin’s memoir, the former Clinton Treasury secretary recounts bail-out after bail-out during the 1990s, arguing in each case that the Fund’s actions did not stoke moral hazard. Why then did spreads rise so much in the years after the Fund belatedly cut the cord in Russia? No, the right future for the Fund, as for the IBRD, is to phase itself out of the lending business. The Fund can still make itself very useful in co-ordinating the global financial system, in offering technical advice, and perhaps even in issuing debt ratings to countries that request it. If the global community can work its way towards an improved bankruptcy procedure for sovereign borrowers, this path will be far easier. I would recommend it regardless.

The Bretton Woods sisters have reinvented themselves more than once during their first 60 years. They can do it once more—and they need to.

Kenneth Rogoff is a professor of economics at Harvard University. He was previously chief economist and director of the research department at the International Monetary Fund.